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SUBJECT: FRENCH TAX REFORM PACKAGE

REF: (A) Paris 2089; (B) Paris 2003

¶1. SUMMARY: New French Finance Minister Christine Lagarde introduced a tax reform bill on June 20 "in favor of labor, employment and purchasing power". The cost of the tax package could mean the government budget deficit in 2007 and 2008 will again exceed the EU-imposed limit of 3 percent of GDP. The impact of the package on economic growth is likely to be modest in 2007 and slightly more significant in 2008. END SUMMARY

Exempting from Taxes Overtime Work

¶2. Finance Minister Christine Lagarde introduced a tax reform bill on June 20. The eight-chapter tax bill includes details of measures the GoF had announced in May. . The tax package includes tax exemptions on overtime work to encourage companies to increase employment, which would allow employees to increase working hours and thus their purchasing power (ref A). The bill proposes overtime work rates to be paid on the basis of collective agreements, and if there are none, at legal rates (25 percent or 50 percent more than normal hours) to employees working full time, and at 25 percent to employees working part time. The key measure of the scheme is the proposal to exempt overtime work from income taxes and payroll taxes. Exemptions will apply to both private-and government sector employees, who will benefit from exemption of both income tax and payroll taxes including the contribution on all incomes (CSG) and the contribution for the repayment of the social security debt (CRDS). In the civil service sector the scheme will be negotiated with unions before the publication of decrees. For special regimes (e.g. railroad company SNCF, railway company RATP, etc.), the implementation of the scheme raises a number of questions that will need to be resolved because changes to the transportation sector are politically difficult. The government took into account recommendations of the supervisory State Council ("Conseil d'Etat", which assists the Executive with legal advice) on executives and part-time employees. Executives working above the 1607-hour quota or giving up rest days above the annual 218-day quota would benefit from exemptions. Tax exemption for part-time employees working above the contractual work duration would be increased from 10 percent to 30 percent.

¶3. For their part, employers would be exempted from payroll taxes on overtime work depending on employees' positions and the size of the companies: 0.50 euro per overtime worked hour in companies with more than 20 employees and 1.50 euros in companies with less than 20 employees. Payroll taxes on overtime by employees in low wage positions in those companies would be fully offset. The scheme, which should become effective on October 1, 2007, would be subject to an evaluation by July 1, 2009.

Exempting Students from Income Taxes

¶4. To improve the financial situation of young students who work to finance their studies, the proposal would extend income tax exemptions to all income earned by students younger than 25. The annual ceiling for exemption would be three times the monthly minimum wage or 3,750 euros. Students would still have the choice to opt for the Earned Income Tax Credit if that solution is more favorable.

Implementing Tax Credit on Mortgage Interests

¶5. Presently, only 56 percent of French households are landlords of their main residences, while the average in Europe is 75 percent. The tax package proposes tax credits for the acquisition or the construction of a main residence. This new advantage, which adds to the current zero-interest rate loan scheme aimed at modest-income earners, would also benefit non-taxable households via a repayment. New home buyers would be allowed to deduct from their income taxes 20 percent of their mortgage interest in the first five years. This measure would apply to both existing and new loans, for any interest due after the first day following the implementation of the tax bill. This measure, which is one of the top topics of conversation among the French, caps the tax break at 3,750 euros for singles and 7,500 euros for households plus 500 euros per dependent child.

Reducing Inheritance taxes

¶6. New measures would exonerate 9 out of 10 people from inheritance taxes, and would bring France more in line with most other European countries. The tax package eliminates inheritance taxes for the surviving spouse or the surviving partner linked by a civil solidarity pact (PACS). Partners linked by a "PACS" would benefit from the same tax exemption as spouses on gifts below 7,600 euros,

and would be subject to the same rates of taxation (5 percent to 40 percent versus 40 percent and 50 percent currently) for gifts exceeding 7,600 euros. Measures also include reducing inheritance and gift taxes in favor of ascendants and descendants or between brothers and sisters on inheritances up to 150,000 euros (versus up to 50,000 euros). Gifts in favor of a child, a grand-child, a grand-grand child (or a nephew or a niece if there are no such inheritors) would be exempt up to 20,000 euros. The inheritance tax reform would be applicable as soon as the law is published in the French Official Journal. An exception is made for stock options.

¶7. Stock options: the tax package proposes to submit the exercise of options in case of gift or sale to the tax regime applicable to the attribution of free equities. The idea is to ensure that the increase in personal exemption applicable to inheritances (new version) does not benefit stock options. The Confederation of Businessmen (MEDEF) succeeded in obtaining agreement that taxation would be applicable as of June 20, 2007, and not retroactively.

Reducing Absolute Tax Ceiling of No more 50 Percent
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¶8. Since January 1, 2007, direct taxes paid by an individual cannot exceed 60% of his or her income. Taxpayers may ask for a refund of payments exceeding that threshold. The tax ceiling includes income tax, wealth tax, and local taxes paid for the main residence, but not the contribution on all incomes "CSG" and the contribution to the repayment of the social debt "CRDS." The reform bill proposes to include CSG and CRDS, and to reduce the amount of direct taxes paid by a taxpayer from 60 percent to 50 percent of income. The goal is "to improve the attractiveness of the tax system, and to give new confidence to investors in favoring the return in France of all talents that France needs." The measure would apply on January 1, ¶2008.

Exempting from Wealth Tax Investments in SMEs

¶9. To attract further investment in small- and medium sized companies, the government now proposes to exempt from the wealth tax 75 percent of any investment in SMEs (or enterprises inserting the jobless, education and research establishments, and public utility

foundations) up to 50,000 euros. The measure would apply on June 20, 2007 on investment, and be included in the calculation of the wealth tax on January 1, 2008.

Subordinating Golden Parachutes to Performance
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¶10. Golden parachutes, which are not affected by tax measures, were nonetheless included in the tax package. Sarkozy described "golden parachutes for top executive as intolerable" (ref B), saying the government wants to modify the system as soon as possible. Sarkoky said "the measure is very simple, and will consist in linking the existence of departure bonuses, which have to be approved by the board of directors, to the performance of the executive", commenting "no performance, no premium." The scheme also aims at improving the transparency of executive rewards and maintaining France as an attractive place to do business.

Creating Active Solidarity Income

¶11. Local governments ("departements") may volunteer to experiment with an "Active Solidarity Income," which should guarantee for three years an increase in incomes for all beneficiaries of the minimum income ("Revenu Minimum Income - RMI") who find jobs. The scheme would offset the loss of allowances paid or advantages to RMI beneficiaries. A similar scheme could be put in place for "isolated parents," who get specific allowances.

Cost of the Tax Package

¶12. Prime Minister Francois Fillon outlined the total cost of the tax package (11 billion euros or 0.6 percent of GDP): "between 5 and 6 billion euros in overtime work exemption, 3 billion euros in tax deduction of mortgage loans and 1.7 billion euros in reduced inheritance taxes." Critics, including former socialist Minister of Finance Dominique Strauss-Kahn, charged that the tax package would be extremely costly (at least 15 to 20 billion euros) at a time when the GOF is trying to bring spending under control. Sarkozy and Fillon reiterated that the cost would be offset by higher tax receipts resulting from higher economic growth, and cuts in budget expenditures with the elimination of one out of two retiring civil servant positions (30,000 to 40,000 total positions to be cut in 2008) and cuts in social security expenditures. A 50 percent cap on income taxes would not prove a drain on government coffers because "if it works, it will reduce capital outflows." The government

forecasts its budget deficit to decrease to 2.4 percent of GDP in 2007 and to 1.7% in 2008 partially due to the tax package. That strategy should worry the European Union, which wants France to rein in its government budget deficit. France has attempted to reassure its euro zone partners about its plan to foster economic growth with tax cuts. Former finance minister Jean-Lous Borloo (now Minister of Environment, Sustainable Development and Planning) left Luxemburg Prime and Finance Minister Jean-Claude Juncker with no doubt on June 4 that France would respect the EU Stability and Growth Pact. Sarkozy subsequently reaffirmed that France will balance its budget by 2012. That said, Philippe Seguin, the head of the Public Accounts watchdog ("Cour des Comptes") recently acknowledged that public finances have improved, but warned they remained "fragile."

Reactions to the Tax Package

¶13. The daily left-wing newspaper Liberation argues that Sarkozy's tax package will increase the gap between the classes, "favoring the richest and best-placed French." The daily Le Monde remarks that the real efficiency of the measure in favor of overtime work requires companies to have order books full enough, and favors employees, not the unemployed. Unions have focused on perverse effects of the tax exemption of overtime work since the cost of overtime work will be lower than that of regular work hours. On their part, some economists find the overtime scheme too complex. The new government spokesman Laurent Wauquiez admitted that the overtime work scheme could "evolve" during the examination of the tax package by the new National Assembly in early July. Morgan Stanley senior economist Eric Chaney asserted that tax breaks for

existing housing loans are only tax gifts, "which will increase the budget deficit without helping the economy to grow faster." In contrast, tax breaks for new housing loans and "more substantial reforms" including tax breaks for overtime "go in the right direction, albeit, regrettably, with some fiscal laxity." Chaney raised its GDP forecast for France in 2008 to 2.3 percent from 2.2 percent, and government deficit forecast from 2.6 percent of GDP to 2.7 percent in 2007, and from 2.7 percent of GDP to 2.9 percent in
¶2008.

President: Tax Package is a Step

¶14. Sarkozy says that the tax package is only a first step. In explaining his economic program for the next five years to UMP deputies and also to the French on the TF1 TV channel on June 21, he said he wanted to give a new impulse to reforms, reiterating plans for a minimum service in public transportation and giving autonomy to universities (ref B), reform taxes and social contributions "to encourage labor, production and investment", reform of the minimum wage income ("SMIC"), end of early retirements, new limits ("franchises") to health repayments, and quicker moves in the government reform. Sarkozy also said he did not rule out the implementation of a social VAT to fund health expenditures, although opponents argued it would raise prices, cut domestic consumption, dampen economic growth and increase joblessness. Sarkozy said "we haven't yet decided anything. If we find that social VAT did show that it facilitates job creation, we'll do it, but not before 2009; if it didn't show, we'll not do it." The union of farmers (FNSEA) opined they were ready to experiment with a social VAT, arguing it would be painless to the French consumers if the government reduces social taxes paid by farmers.

Comment

¶15. The tax package should be easily passed during the summer session ending August 10 by Sarkozy's UMP party, which controls a large majority of seats at the National Assembly. The impact of the package on economic growth will be modest in 2007 (septel) since measures will take place in the second half, but should be more significant in its full year of implementation, in 2008. The main risk of the tax package is an increase in the government budget deficit. Nevertheless, the wave of structural reforms announced by Sarkozy will help boost potential economic growth in the medium term. Investors and companies welcome reform plans as they are widely seen as positive for the French economy.

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